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It's time to cap tax deductions

By Martin Feldstein, Published: March 12

Martin Feldstein, a professor of economics at Harvard University and president emeritus of the nonprofit National Bureau of Economic Research, was chairman of the Council of Economic Advisers from 1982 to 1984.

President Obama's recent meetings with members of Congress have raised hopes that a major fiscal deal will replace the "sequester" and put the federal debt on a healthier long-term path. But the key barrier to such a deal remains the disagreement between Republicans and Democrats about the balance between raising revenue and cutting government spending. Republicans say they are against any further increase in taxes. Democrats, including the president, say that any budget deal must include additional revenue as well as spending cuts.

Fortunately, Democrats indicate that they want to raise the extra revenue without increasing tax rates. Raising revenue without increasing tax rates requires eliminating or reducing the subsidies in the U.S. tax code. Such subsidies, for things as varied as hybrid cars and increased health insurance, are really the government spending through the tax code. That is why they are officially referred to as "tax expenditures."

Reducing those subsidies, then, is really cutting government spending. The resulting deficit reductions show up on the revenue side of the budget, but the economic effect is to cut government spending.

Billions of dollars of revenue are lost through many relatively small subsidies, such as the tax break given to homeowners who install better insulation or buy a more efficient refrigerator. These may be desirable actions, but given the current budget situation, the country cannot afford to subsidize them. Anyone opposed to government spending should favor removing these subsidies from the tax code.

The big political challenge is dealing with the large tax subsidies to home mortgages, employer-provided health insurance and state and local taxes. Any attempt to eliminate these would almost certainly fail to get enacted. That is why I advocate allowing taxpayers to keep all of their current deductions and exclusions — but limiting the extent to which they can reduce their tax liabilities in this way.

More specifically, I believe that Congress should cap the reduction in tax liabilities that taxpayers can gain from using these special features of the tax code. The tax benefits should be limited to a percentage of the individual's total income. I favor a cap of 2 percent of adjusted gross income (AGI) on the tax benefit that an individual receives from deductions and from the exclusion of municipal bond interest and of the value of employer payments for health insurance. For someone with a 25 percent marginal tax rate, that 2 percent limit on the reduction in taxes translates into a limit of 8 percent of AGI on the deductions and exclusions.

This cap should be applied to all deductions except the one for charitable contributions. The full deduction for charitable contributions should be retained, because the money that taxpayers give to charity benefits those organizations rather than the individual taxpayer.

A 2 percent limit on the tax benefit from deductions and exclusions would produce about $140 billion in additional revenue if it were applied in 2013. Over the next decade, the additional deficit reduction would total more than $2.1 trillion. With that much extra revenue from tax reform, it would be possible to cut some marginal tax rates.

The president has proposed raising revenue by limiting tax subsidies, but his plan would affect only high-income taxpayers. Under his proposal, taxpayers would keep all of their deductions, but deductions would be limited to a 28 percent tax rate. Someone in the 35 percent bracket who spends $20,000 on mortgage interest, for example, would reduce his tax liability not by 35 percent, or $7,000, but only by 28 percent of the $20,000, or $5,600.

The president's plan, unfortunately, is inadequate and unfair. It would raise only $21 billion if applied to 2013 and about $300 billion over the next decade. That's less than one-sixth of the deficit reduction achieved by a 2 percent cap on tax benefits. And virtually all of that money would come from taxpayers earning more than $200,000. Any serious plan to reduce government spending that is built into tax law should raise more revenue and call on most taxpayers to participate.

Tax reform can play a key role in reducing future budget deficits and in making tax law simpler, fairer and more supportive of stronger economic growth. Republicans should recognize that limits on tax subsidies are reductions in government spending. And if Republicans agree to a substantial revenue increase in this way, Democrats should agree to significant structural changes to slow the growth of Social Security and Medicare.

The key to breaking the fiscal impasse is to reduce the government spending done through the tax code.

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